Proposition 24

Repeals Recent Legislation That Would Allow Businesses to Carry Back Losses, Share Tax Credits, and Use a Sales-Based Income Calculation to Lower Taxable Income. Initiative Statute.

Background

This proposition would change three provisions of California's laws for taxing businesses. As indicated below, these provisions have been changed recently as part of state budget agreements between the Legislature and the Governor. Under current law, all of these recent changes will be in effect by the 2011 tax year.

Businesses' Use of Financial Losses. Under federal and state tax laws, in a year when a business has more deductible expenses than income, the business has a net operating loss (NOL). A business with an NOL in one year generally can use it to reduce its taxes when it makes a profit in some later years. This is known as a "carryforward" of losses. Federal tax law also allows businesses to "carry back" losses. In other words, federal law allows a business to use an NOL from one year to reduce its taxes in an earlier year. These mechanisms—both carryforwards and carrybacks—have been put in place to recognize that business income and/or expenses can vary significantly from year to year.

A law approved by the Legislature and the Governor in 2008 allows carrybacks for state business taxes for the first time, starting in 2011. Specifically, this new law will allow a business to use an NOL from 2011 or later to reduce its state taxes for the two years before the NOL was generated. For example, a business that had profits and paid taxes in 2009 but has a loss in 2011 may deduct its 2011 NOL against its 2009 taxable income. The business would file an amended tax return for 2009 and receive a tax refund. In addition, the 2008 law extends the carryforward time allowed from 10 years to 20 years.

Determination of Income of Multistate Businesses' Taxed by California. Businesses often operate in many states. To determine how much of the income of a multistate business is taxed by the state, California law now uses a formula that involves three factors:

- ***Property.*** The value of the business' properties in California compared to the value of its properties throughout the nation.
- ***Payroll.*** The value of the business' compensation to its employees in California compared to the value of its compensation to its employees throughout the nation.
- ***Sales.*** The value of the business' sales in California compared to the value of its sales throughout the United States. (For most businesses, this factor counts more heavily than the others.)

A law approved by the Legislature and the Governor in 2009 will give multistate businesses a new way to determine how much of their income that California taxes. Starting in 2011 under this new law, most multistate businesses will be able to choose each year between two formulas to set the level of income California can tax.

Businesses' two options will be: (1) the three-factor formula currently in use (described above), or (2) a new formula based only on the portion of their overall national sales that are in California (known as the "single sales" factor). A business typically will select the formula that minimizes its California taxes. A business would be allowed to switch back and forth between the two formulas.

Ability of Businesses to Share Tax Credits. California tax law allows tax credits that can reduce a business' taxes. If, for example, a business is able to use tax credits worth $1 million, this reduces the business' state taxes by $1 million. These tax credits are given to businesses doing certain things that the state wants to encourage. For example, a business that spends money in California to develop a new technology product may earn a "research and development" tax credit. If a business has credits which exceed the amount of taxes it owes in a given year, it will have unused credits. (Typically, these unused credits can be carried forward to be used in future years.)

Many business organizations consist of a group of business entities. This is called a "unitary group" if it meets certain conditions, such as operating jointly or operating under the same management. For example, one business in a group may develop a product, and another business in the group may sell that product. Tax credits are given to individual business entities—not unitary groups.

A law approved by the Legislature and the Governor in 2008 allows a business with available tax credits to transfer unused tax credits to another business in the same group. Shared credits can be used to reduce taxes in 2010 and later years. There are certain limitations to this credit sharing in the law. Some of these credits have been transferred already.

Proposal

This proposition repeals the business tax law changes passed in 2008 and 2009 described above. As such, this measure would return tax policies in these areas to the way they were prior to the recent law changes. The effects of this proposition are summarized in Figure 1.

Figure 1

Effects of Proposition 24 on California Business Tax Law

Issue	Prior Law[a]	Current Law	Law if Proposition 24 Passes
Use of Operating Losses	*Carrybacks.* Business losses cannot be used to get refunds of taxes previously paid.	*Carrybacks.* Beginning in 2010, business losses can be used to get refunds of taxes paid in the prior two years.	Same as prior law.
	Carryforwards. Businesses can use losses to offset income in the 10 years following the loss.	*Carryforwards.* Beginning in 2010, businesses can use losses to offset income in the 20 years following the loss.	Same as prior law.
Income of Multistate Businesses	A single formula determines the level of a multistate business' income that California taxes based on the business' sales, property, and payroll in California.	Beginning in 2011, most multistate businesses will choose every year between two options to determine the level of income that California can tax: (1) the formula under prior law, or (2) a formula that considers only the business' sales in California relative to its national sales.	Same as prior law.
Tax Credit Sharing	Tax credits given to a business entity can only reduce that entity's taxes. That entity cannot share its tax credits with entities in the same group of businesses.	Beginning in 2010, tax credits given to a business entity can be used to reduce the taxes of other entities in the same group of related businesses.	Same as prior law.

[a] State law prior to changes adopted as part of 2008 and 2009 budget agreements.

Restricts Ability of a Business to Use Operating Losses to Lower Taxes. This proposition prevents a business from using an NOL carryback to reduce its taxes for previous years. Businesses could still use NOLs to reduce their taxes in future years—though they would have 10 years to use each NOL, rather than 20 years.

Ends Ability of a Multistate Business to Choose How Its California Income Is Determined. This proposition eliminates the option that multistate businesses will have to choose between two formulas to determine the portion of their income subject to California state taxes. Instead, businesses' taxable income in California would continue to be determined based on the formula currently in use which considers businesses' sales, property, and payroll. (The tax law used for businesses that only do business in California would be unchanged by this part of the proposition.)

Ends Ability of a Business to Share Tax Credits Within a Unitary Group. This proposition prevents business entities within a unitary group from sharing tax credits in the future. (While it is not certain, it appears that businesses would be able to use tax credits that already have been transferred to them.)

Fiscal Effects

Increased State Revenues. This proposition would increase state General Fund revenues by increasing the taxes paid by businesses. When fully implemented by 2012-13, revenues would increase by an estimated $1.3 billion each year. There would be smaller increases in 2010-11 and 2011-12. More than one-half of these estimated

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increased taxes would be paid by multistate businesses as a result of the elimination of the single sales factor option.

Effects on Education Funding and the State's General Fund. Proposition 98 (passed by the voters in 1988) determines the minimum amount of state and local funding for K-12 schools and community colleges each year. Under the formulas of Proposition 98, a significant part of Proposition 24's revenue increases would be allocated to schools and community colleges. The remaining revenues would be available to the Legislature and the Governor for any purpose.

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